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Editorial

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EDITORIAL

Certification According to Instruction

It is reported that a state banking commissioner has recently issued, in reference to certification of accounts, a ruling which we believe is entirely unique and quite undesirable. The story goes that the ruling requires that the accountant who audits the accounts of building and loan associations must follow a fixed formula which leaves no latitude at all for qualification or explanation. The certificate must state that in the opinion of the accountant the accounts are correct or else the accountant must refuse to certify. This is very much like the rule of court that where a witness can answer yes or no he must do so; but it is well known that many questions will not permit adequate reply without some explanatory comment. The bank commissioner is said to have made his ruling to avoid a multiplicity of qualifications in certificates, many of which might be unintelligible to the share-holder. Consequently he has decided that there must be this fixed form which we have mentioned and beyond that nothing whatever so far as the certificate itself is concerned. But the commissioner evidently recognizes the necessity for something more comprehensive than a mere yes or no answer, because the ruling provides further that if any explanation is necessary it may be reported to the directors of the association for their information. The accountant, therefore, if this ruling holds, will find himself in an extremely awkward position. There may be, and probably will be, many instances in which he will feel that his duty

to the share-holder calls for exposition of reasons and facts for the protection of the share-holder himself.

No Restriction Should be Permissible

There is, as everyone knows, a marked trend today toward better and more indicative financial reports, and accountants throughout the country, responding readily to the demand for greater frankness, are making every effort to present reports and certificates which carry to the reader all the knowledge of the facts to which the reader is entitled. Now comes this extraordinary ruling of a state banking commissioner, which looks like a reversion to the dark ages, when the share-holder was unimportant and was not told any more than the directors thought was good for his soul. There are very few accounts which can be certified without some explanatory phrase or sentence in the certificate. This does not mean that there need be anything wrong in the accounts themselves or in the financial condition of the company. It does mean that there are things which can not be classified as correct or incorrect without a few words of qualification. Indeed, there are probably many cases in which a monosyllabic response to the question: Is this correct or not? would be misleading. If the banking commissioner's rule is followed the accountant who finds that some qualification is necessary will be obliged to refuse to certify in the short form which is desired by the commissioner, and it is easily conceivable that such a refusal to certify might work an injury to the association in question. If the accountant had audited the accounts of a building and loan association and because of this restrictive ruling refused to certify, the share-holders and the general public as well might be forgiven for coming to the conclusion that the association was in an unsound condition, when as a matter of fact it might be prosperous and its affairs in perfect order.

Refusal to Certify May be Unfair

A fine legal point might then arise as to the liability of the accountant who refused to certify and thereby involuntarily cast upon the association a shadow of doubt. Perhaps the defense of the banking commissioner would be that any qualifications or explanations addressed to the directors would be sufficient indication of the accountant's opinion; but as a matter of fact letters to boards of directors are not public property and usually are not accessible to share-holders. There is nothing new in this

contention. In an English case involving the London and General Bank, Limited, in 1895, the decision of the court of appeals contained the following:

". . . The balance-sheet and certificate of February, 1892—that is, for the year 1891—was accompanied by a report to the directors of the bank. Taking the balance-sheet, the certificate, and report together, Mr. Theobald (the auditor) stated to the directors the true financial position of the bank, and if this report had been laid before the share-holders, Mr. Theobald would have completely discharged his duty to them. Unfortunately, however, this report was not laid before the share-holders, and it becomes necessary to consider the legal consequences to Mr. Theobald of this circumstance. A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them to ask for more. Information and means of information are by no means equivalent terms. In this case I have no hesitation in saying that Mr. Theobald did fail to discharge his duty to the shareholders in certifying and laying before them the balance-sheet of February, 1892, without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words 'The value of the assets as shown upon the balance-sheet is dependent upon realization' . . ."

An accountant who did obey such an absurd ruling as that which is the subject of present consideration would be not only unwise but untrue to his professional duty. There is a rather strong sentiment in favor of the shortest form of certificate which can express the accountant's opinion. There is no advantage in long and involved certificates; but brevity can be carried to the point of obscurity. It is ridiculous to attempt to limit to any specified form an expression of professional opinion, and no professional man should submit to arbitrary limitation of that sort. Probably the ruling which has been reported to us will arouse so much protest that it will have to be rescinded or so modified as to make it harmless. The principle involved, however, is important, and accountants should be on guard to check every effort to place a restraint upon their professional freedom of action. Every accountant has had experience of clients who wish to dictate the form of certificate—and we hope that every accountant has declined to accept any such dictation. The moment any professional man allows his professional liberty to be thus bounded, he makes his standing in the profession insecure. What reason may have animated the banking commissioner to utter such a ruling as that which we have described is unknown. There seems

to be no logical excuse for it. It would be unacceptable to shareholder, accountant, the state department of banking and the general public. In fact, it is difficult to think of any benefit which could accrue from its enforcement. It seems probable, therefore, that it was merely an ill advised effort to standardize something which can not be absolutely standardized.

Two-Class Legislation Decried

Among the many valuable reports which were presented by committees at the annual meeting of the American Institute of Accountants last October was one emanating from the committee on state legislation. This report contained a survey of that form of certified-public-accountant legislation which has been variously described as "two class," "restrictive," etc. The laws which fall in this category provide for the registration of all men and women engaged in professional practice as accountants at the time of the enactment of the law. Thereby they create two sorts of licensed accountants: the certified public accountant and the registered public accountant. They provide also that there shall be no further accessions to the list of registered accountants. The natural result of this closing of the doors will be the gradual elimination of all professional accountants except those who are and those who will become certified public accountants. The report is an extremely able review of the supposed advantages and the manifest disadvantages of this kind of legislation, and the committee deserves commendation for the careful and thorough investigation which must have preceded the writing of the report. It is not necessary to reproduce the entire report, but the following preamble and resolution submitted by the committee to the council so comprehensively covers the subject that there is little to be added:

WHEREAS, the certified-public-accountant certificate is the recognized legal credential of professional public accountants in the United States, and

The business public has come to regard certified public accountants as qualified practitioners of accountancy, and

Passage of so-called restrictive accountancy laws necessarily extends state recognition to unaccredited accountants in practice at the time of enactment of such laws, and

Such recognition dilutes the value of the certified public accountant certificate by creating confusion in the public mind as to the distinction between certified public accountants and other licensed public accountants, and

Experience has shown that such recognition strengthens the political position of non-certified public accountants, facilitates their organization as a group and frequently results in efforts to obtain certified-public-accountant certificates by waiver, and

WHEREAS, restriction of the practice of accountancy would necessarily limit the definition of accountancy to only a few of the services which certified public accountants now customarily perform, and

WHEREAS, court decisions indicate that restrictive accountancy laws of the type proposed up to this time are apt to be unconstitutional,

Be It Resolved, that the council of the American Institute of Accountants regards the passage of restrictive accountancy laws of the so-called two-class type as inimical to the interests of the certified public accountant and of the business public.

Decision Not Hastily Made

After consideration of the report the council unanimously adopted the resolution. It is quite easy to understand why the restrictive or two-class form of bill has met with some support. At first glance it seems to offer a protection against extra-state competition, because it is not to be expected that an accountant, going into a foreign state for the purpose of completing an engagement, would care to go through the formalities and delays entailed by an effort to obtain a certificate in that state; and it might seem to the casual observer that the effect of this sort of law would be to strengthen the position of the accountants within each state. There has been in accountancy, as in every other profession, a good deal of dissatisfaction because of the encroachment upon local practice by men whose wider reputation has induced their employment by clients within a state. Nobody likes to feel that a practitioner from beyond the bounds of his own state is preferred to himself. This has been one of the causes of such support as has been rendered to the theory of restrictive legislation. The other contributing causes are indicated in the preamble of the resolution which we have quoted. We believe, however, that the great majority of accountants would oppose the adoption of the principle of restriction; and the fact that the Institute's council, representative of all parts of the country, unanimously adopted the resolution lends credence to our contention. This matter has been discussed more or less informally at many meetings of the council and of the Institute as a whole, but there was some hesitation about taking a definite stand until the

experiment had had ample trial and opportunity to demonstrate its effects. Now it has seemed to the council that no further period of experiment is necessary and the resolution definitely places the Institute on record as opposed to what is generally regarded as an undesirable development of C. P. A. legislation.

Similar Action in New York

Following the meeting of the Institute at which the report of the committee on state legislation was considered and its recommendations were adopted, the committee on legislative survey of the New York State Society of Certified Public Accountants presented to that society a report upon the same subject. From this report we quote the following paragraphs:

"The particular problem seems to resolve itself into a question of whether the society should continue the position it has heretofore taken in favor of the so-called 'open-door' policy under which anyone might practise as a public accountant (but with strict limitation of the right to use the title of certified public accountant), or whether there should be some form of restrictive legislation which would bar from the public practice of accountancy in this state all those who were not recognized by the state as authorized so to practise.

"We are, however, prepared to say that we believe the society should not at the present time change the position it has heretofore taken against various proposals for restrictive legislation. This position is stated without believing that the society should say whether or not at some future date it might see some form, type or basis for restrictive legislation and control which it might feel would be appropriate or desirable or at least free from serious objection. . . .

"While we have heretofore expressed in this report the thought that the society should not at the present time change the position it has heretofore taken against restrictive legislation and while we would not wish here to weaken or in any way void that expression, we may state that there stand in our minds certain points without which no restrictive legislation in any event should receive the approval of the New York state society."

The report of the New York committee on legislative survey was presented to the society at a meeting on October 29, 1934, and after discussion was accepted. We find, therefore, that, while the attitude of the New York state society was not so definite as that adopted by the American Institute of Accountants, there was practical agreement between those two organizations. The state society's stipulation of seven qualifications which all restrictive laws would have to meet to be acceptable to the society seems

to us to be tantamount to opposition to the two-class laws now in effect and to any scheme of similar legislation apt to be devised.

Development of Accounting Principles

One of the most important committees of the American Institute of Accountants is that which is known as the special committee on development of accounting principles. This is a new committee, appointed for the first time last year, but the accomplishments and purposes of the Institute since its inception have been largely concerned with the survey and analysis of the underlying principles which should govern the practice of accountancy. The appointment of the committee was merely putting in more concrete form the purpose of the whole organization. The committee consists of the chairmen of several committees and thus is representative of a large group of competent accountants. Its opinions and recommendations are worthy of close consideration. The report of the committee which was submitted at the meeting of council of the Institute October 15, 1934, was published in the *Bulletin* of the Institute. Attached to the report was a statement of certain principles which were enunciated by the Institute's committee on coöperation with stock exchanges. (These rules have already appeared in THE JOURNAL OF ACCOUNTANCY.) When the report of the special committee was reported to the council in October the rules were unanimously approved.

Treatment of Donated Stock

Special interest attaches to another section of the report of the special committee on development of accounting principles. The undesirable practice which gave rise to a new recommendation was discussed in these pages in October, 1934, in the course of comments upon the decision of the federal trade commission in the case of the Unity Gold Corporation. The committee recommended that the Institute put itself on record as to the treatment to be applied to a series of inter-related transactions comprising:

1. The issue of capital stock of a corporation ostensibly for property;
2. The donation of a part of such stock to the corporation;
3. The sale of a part of the donated stock for cash by the corporation.

The report of the committee continued:

"In the past it has not been uncommon, especially in the case of corporations formed to develop a new mine, to charge the par value of the stock issued to property account and to credit to surplus the cash received from the sale by the corporation of the stock donated to it. It is clear, however, that such a procedure results in an overstatement of the property account and of the surplus account.

"During the year, a registration statement in which this procedure had been followed was disapproved by the federal trade commission, and the committee believes that the Institute should also indicate its disapproval. Your committee, therefore, recommends that the following rulings on this point should receive the formal approval of the Institute:

> "If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.

"Your committee believes that members of the Institute should recognize an obligation, in any case in which they are called upon to prescribe or pass upon the treatment of capital stock donated to a corporation, to satisfy themselves that the transaction is a gift in good faith and is not an artificial or unsubstantial transaction designed to create an improper credit to surplus."

We are glad to report that these recommendations received the unanimous approval of the council. The evils which have arisen in the past from improper treatment of the exchange of capital stock for property and in the treatment of donated or redonated stock have been largely due to adherence to tradition, which had nothing to recommend it except a desire to present an appearance of prosperity when in fact operations had not yet revealed the probable fate of the issuing corporation.